Dutch Baby Milk Industries (M) Bhd v Ketua Pengarah Hasil Dalam Negeri

HIGH COURT (KUALA LUMPUR) — TAX APPEAL NO R3–14–3 OF 1998
NIK HASHIM J
30 OCTOBER 1998

Revenue Law — *Income Tax — Deduction — Sum paid as base rental for machinery used — Whether outgoings and expenses wholly and exclusively incurred in production of income*

The appellant was engaged in a food-based industry which manufactured various dairy products for distribution in domestic and international markets. The appellant had paid various types of lease rentals in respect of machinery used, namely: (i) a base rental of Sw Crs 690,000 payable by instalments in respect of machinery No AB3–250, No 1632/6077 and a base rental of Sw Crs 650,900 in respect of machinery No AB3–250, No 1466/5631; (ii) a quarterly rental of Sw Crs 4,864 per quarter payable in advance for each quarter on the 20th day of the first month of the quarter in respect of machinery No 1632/6077; and (iii) a production rental based on the number of filled, sold packages from the machine in respect of both the said machinery. The appellant had paid RM806,077.41 from 1 January 1979 to 31 December 1979 as base rental under two lease agreements in respect of machinery to manufacture ultra heat treated (UHT) milk and fruit juices.

The respondent allowed quarterly and production rental in arriving at the adjusted income for income tax purposes but disallowed the base rental as a revenue business expenses. The dispute regarding base rental was then brought to the Special Commissioners of Income Tax ('the commissioners'). The commissioners held that the base rental was not a 'rental' as envisaged in s 2 of the Income Tax Act 1967 ('the Act'). Accordingly they held that the base rental was capital expenditure. The appellant appealed against the deciding order of the commissioners contending that the base rental are rentals for the hire of machinery and therefore wholly and exclusively incurred in the production of income within s 33(1) of the Act. The respondent on the other hand, submitted that base rentals are premium paid for an enduring benefit.

Held, dismissing the appeal and affirming the deciding orders of the Special Commissioners:

(1) By character and purpose, the expenses paid as the base rental do not qualify them to be revenue in nature. The expenses are not wholly and exclusively incurred in the production of income as they relate to the matter of bringing in the asset, namely the machinery, which is to be put to use in order to produce assessable income. The machinery would not be made available without incurring the expenses. The expenses so incurred as the

base rental are unrelated to the production of gross income. In other words, the obtaining of the machinery is a step preparatory to the earning of income and hence, they are capital in nature. Thus the claim for deduction for the expenses so incurred as the base rental could not be entertained under s 33(1) of the Act and was rightly rejected by the respondent and the commissioners (see p 250A–B).

(2) The decision of the commissioners was not against the facts found. Since the ultimate decision of the commissioners is correct, there is no justification for the court to interfere with their decision (see p 250C–D).

[Bahasa Malaysia summary

Perayu telah terlibat dalam industri berasaskan makanan dan mengeluarkan berbagai hasil untuk edaran di pasaran tempatan dan antarabangsa. Perayu telah membayar berbagai jenis sewa ke atas mesin yang digunakan, seperti: (i) sewa asas Sw Crs 690,000 dibayar secara ansuran bagi mesin No AB3-250, No 1632/6077 dan sewa pokok ke atas Sw Crs 650,900 mesin No AB3-250, No 1466/5631; (ii) sewa setiap suku ke atas Sw Crs 4,864 dengan bayaran pendahuluan dibayar pada hari ke-20 setiap suku bulan pertama ke atas mesin No 1632/6077; dan (iii) sewa hasil berasaskan bilangan yang diisi dan bungkusan yang dijual berkenaan kedua-dua mesin tersebut. Perayu telah membayar RM806,077.41 daripada 1 Januari 1979 hingga 31 Disember 1979 sebagai sewa pokok di bawah dua perjanjian pajakan bagi mesin untuk mengilang susu UHT dan jus buah-buahan.

Responden membenarkan sewa setiap suku dan sewa hasil dalam mendapatkan pendapatan yang diselaras untuk tujuan cukai pendapatan tetapi tidak membenarkan sewa pokok sebagai hasil perbelanjaan perniagaan. Pertikaian mengenai sewa pokok dibawa kepada Pesuruhjaya-Pesuruhjaya Khas Cukai Pendapatan ('pesuruhjaya tersebut'). Pesuruhjaya tersebut telah mengambil keputusan bahawa sewa pokok bukan merupakan 'sewa' seperti yang termaktub dalam s 2 Akta Cukai Pendapatan 1967 ('Akta tersebut'). Sehubungan dari itu, pesuruhjaya tersebut memutuskan bahawa sewa pokok adalah perbelanjaan modal. Perayu merayu di atas keputusan yang diperintahkan oleh pesuruhjaya tersebut dan menegaskan bahawa sewa pokok adalah sewa untuk menyewa mesin dan dengan itu, secara keseluruhan dan ekslusif, termasuk dalam menghasilkan pendapatan dalam lingkungan s 33(1) Akta tersebut. Sebaliknya, responden mengemukakan bahawa sewa pokok adalah premium berbayar untuk mendapatkan faedah yang berpanjangan.

Diputuskan, menolak rayuan dan mengesahkan perintah yang telah diputuskan oleh Pesuruhjaya-Pesuruhjaya Khas:

(1) Berdasarkan sifat dan tujuannya, perbelanjaan yang dibayar sebagai sewa pokok tidak melayakkannya sebagai hasil. Pebelanjaan tersebut tidak keseluruhan dan ekslusif ditanggung sebagai hasil pendapatan sebagaimana ia dikaitkan untuk menghasilkan harta, seperti mesin-mesin, di mana ia digunakkan untuk menghasilkan pendapatan yang diperolehi. Mesin tidak dimiliki tanpa tanggungan perbelanjaan. Perbelanjaan yang ditanggung sebegitu sebagai sewa pokok adalah tidak berkaitan dengan hasil pendapatan kasar. Dengan kata lain, perolehan mesin-mesin adalah salah satu langkah persediaan untuk menghasilkan pendapatan dan, dengan sendirinya, ia adalah bersifat modal. Oleh itu, tuntutan pengurangan perbelanjaan yang ditanggung sebagai sewa pokok tidak boleh dilayan di bawah s 33(1) Akta tersebut dan penolakan oleh responden dan pesuruhjaya tersebut adalah betul (lihat ms 250A–B).

(2) Keputusan pesuruhjaya tersebut tidak bercanggah dengan fakta yang ada. Oleh kerana keputusan muktamat pesuruhjaya adalah betul, tidak ada sebab mahkamah perlu campur tangan dalam keputusan yang telah diputuskan (lihat ms 250C–D).]

Notes

For cases on deduction for the purpose of income tax, see 10 *Mallal's Digest* (4th Ed, 1996 Reissue) paras 1796–1822.

Cases referred to

Commissioners of Inland Revenue v Wesleyan & General Assurance Society 30 TC 11 (refd)

Ketua Pengarah Hasil Dalam Negeri v Seabanc Kredit Sdn Bhd [1988] 2 AMR 1270 (refd)

Strick v Regent Oil Co Ltd [1964] 3 All ER 23 (refd)

Legislation referred to

Income Tax Act 1967 ss 2(1), 33(1)

Arjunan Subramaniam (*Fateh Hanum bte Khairuddin* with him) (*Shook Lin & Bok*) for the appellant.

Ahmad Khairuddin bin Abdullah (Legal Officer, Lembaga Hasil Dalam Negeri) for the respondent.

Cur Adv Vult

Nik Hashim J: Dutch Baby Milk Industries (M) Bhd ('the appellant') appeals against the deciding order of the Special Commissioners of Income Tax ('the commissioners') dated 24 May 1997, disallowing for the purpose of income tax RM806,077.41 which the appellant had incurred as base rental under two lease agreements in respect of machinery to manufacture ultra heat treated (UHT) milk and fruit juices.

The facts

The appellant is engaged in the food-based industry, namely, the manufacture of condensed milk, milk powder, dairy products and fruit juices for distribution in domestic and international markets. The following types of lease rentals were paid in respect of the machinery by the appellant:

(a) a base rental of Sw Crs 690,000 payable in instalments; $^1/_3$ at the signing of lease agreement, $^1/_3$ at the dispatch of the machine from a Swedish port and $^1/_3$ when the machine has arrived at the port of destination (ie a Malaysian port) in respect of machinery No AB3–250, No 1632/6077 and a base rental of Sw Crs 650,900 in respect of machinery No AB3–250, No 1466/5631;

(b) a quarterly rental of Sw Crs 4,864 per quarter payable in advance for each quarter on the 20th day of the first month of the quarter in respect of machinery No 1632/6077. The quarterly rental for machine No AB3–250 No 1466/5631 is not stated in the lease agreement; and

(c) a production rental based on the number of filled, sold packages from the machine in respect of both the said machinery.

The appellant paid RM806,077.41 in the basis period from 1 January 1979 to 31 December 1979 as base rental for the machinery as follows:

Machine No	Base Rental	Duty Inwards & Installation Charges	Total
1632/6077	RM365,767.62	RM69,426.31	RM435,193.93
1466/5631	RM340,144.24	RM30,739.24	RM370,883.48
			RM806,077.41

The respondent allowed the quarterly rental and production rental in arriving at the adjusted income for income tax purposes but disallowed the base rental as a revenue business expenses and raised the following assessment:

Year of Assessment	Date of Assessment	Amount
1980	12 June 1982	RM1,096,908.75

There are two issues for the determination by the commissioners:

(1) whether the sum of RM806,077.41 described as base rental paid and incurred by the appellant under the two lease agreements are revenue expenditure which is deductible or capital expenditure which is not deductible under s 33(1) of the Income Tax Act 1967 ('the Act'); or

(2) in the alternative, the amount of RM161,215 in respect of base rentals charged in the appellant's profit and loss account for 1979 be allowed as a deduction for year of assessment 1980 under s 33(1) of the Act (the sum of RM806,077.41 was spread (amortized) over five years, with a charge of RM161,215 for each year).

The finding of the Special Commissioners

The commissioners held that the base rental was not a 'rental' as envisaged by s 2 of the Act but was in fact a premium. They took into account the following facts in arriving at their decision:

(a) two other recurring payments in the form of quarterly rental and production rental were also payable;

(b) the base rental was payable before the installation of the machinery;

(c) there was no definite period in the lease (can be continued or terminated) but the base rental was fixed; and

(d) if the lease agreements are terminated there is no refund of the base rental paid,

and they cited *Strick v Regent Oil Co & Ltd* [1964] 3 All ER 23 as authority for the proposition that a premium payment is a capital expenditure. Accordingly, they held that the base rental was capital expenditure. As such, the commissioners decided that it was not necessary to consider the second issue. Nevertheless, they proceeded to note that how an expenditure is treated in the accounts is immaterial, and cited various authorities (pp 20 to 23 of the case stated).

The contentions of the appellant

Dr Arjunan Subramaniam for the appellant contended that the base rentals are rentals for the hire of machinery and therefore wholly and exclusively incurred in the production of income within s 33(1) of the Act.

The contentions of the respondent

Encik Ahmad Khairuddin bin Abdullah for the respondent, on the other hand, submitted that based on its real character and nature, the base rental could not be rental but a lump sum paid to the lessor for the right to possess and use of the machinery for indefinite period subject to the payment of recurring charges of quarterly rental and production rental. As such, the base rentals are premiums paid for an enduring benefit.

The issue

The real issue in this appeal is whether the expenses paid as the base rental are deductible under s 33(1) of the Act.

The findings of the court

In order to resolve the above issue, I consider it necessary to reproduce the relevant sections of the Act.

Section 2(1) defines 'rent' to 'include any sum paid for the use or occupation of any premises or part thereof or for hire of any thing.

Section 33(1) provides:

> Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all *outgoings and expenses wholly and exclusively* incurred during that period by that person in the production of gross income from that source, ... (Emphasis added.)

'Person' here includes a company (see s 2(1) of the Act).

Having considered the submissions of both sides and the authorities cited before me, I find that on the facts found in the case stated, the conclusion reached by the learned commissioners is correct in law. With respect, I agree with the finding of the learned commissioners that the base rental is not a rental within the definition of s 2(1) of the Act. Eventhough it is called a base rental under the lease agreement, in reality, it is not a 'rent' under the Act. The machine has got to be installed and is in operating condition for sixty (60) days after delivery, whichever is the earlier, before the lease of the machine can be considered to be effective (see cl 111). Once the lease has become effective, then the quarterly rental commences to accrue and the production rental follows based on the number of filled, sold from the machine computed in accordance with the prescribed schedule. In my view, the so-called 'base rental' is indeed the costs of the appellant which it has to pay in order to enter into the lease agreement and to bring the machine to Malaysia. The words 'base rental' are confusing. Equally confusing are labels such as 'advance payment', 'initial payment', 'minimum payment', 'operating expenses', 'rental', 'lump sum', 'upfront' and 'premium' which were used to describe the base rental by the parties. So much time have been spent on arguments on the labels. The issue before the court is not the question of labels, but whether the payments incurred as the base rental is allowable for income tax purposes under s 33(1) of the Act. The court is not concerned with the labels given by the parties to the payment made. What is important is the purpose, character and/or true nature of the payment. As succinctly stated by Viscount Simons in *Commissioners of Inland Revenue v Wesleyan and General Assurance Society* 30 TC 11 at p 25 'the question always is what is the real character of the payment, not what the parties call it.'

Clause IV(a) of the lease agreement is clear in its provision in that it stipulates the base rental of Sw Crs 650,900 and Sw Crs 690,000 are required to be paid in three instalments, namely: (i) $^1/_3$ at the signing of the agreement or if an import licence is necessary, as soon as such licence has been obtained; (ii) $^1/_3$ at the dispatch of the machine from Swedish port; and (iii) $^1/_3$ when the machine has arrived at the port of destination, ie a Malaysian port. Besides the base rental, there are two other recurring payments in the form of quarterly rental and production rental payable under cl IV(b) and (c). With regard to the three types of rentals, the respondent was right to allow the quarterly and production rentals only and reject the base rental for the purpose of income tax allowance under s 33(1)

of the Act. By character and purpose, the expenses paid as the base rental do not qualify them to be of revenue in nature. The expenses are not wholly and exclusively incurred in the production of income as they relate to the matter of bringing the asset, namely, the machinery which is to be put to use in order to produce assessable income. The machinery would not be made available without incurring the expenses. The expenses so incurred as the base rental are unrelated to the production of gross income. In other words, the obtaining of the machinery is a step preparatory to the earning of income and hence, they are capital in nature (see *Ketua Pengarah Hasil Dalam Negeri v Seabanc Kredit Sdn Bhd* [1988] 2 AMR 1270). Thus, the claim for deduction for the expenses so incurred as the base rental could not be entertained under s 33(1) of the Act and was rightly rejected by the respondent and the learned commissioners. By that finding, I consider it is sufficient to dispose of the appeal and accordingly, I do not wish to go into other grounds which to my mind do not merit my consideration.

On the whole, the decision of the learned commissioners is not against the facts found and since the ultimate decision of the learned commissioners is correct, there is no justification for this court to interfere with their decision. Accordingly, I dismiss the appeal with costs to the respondent and the deciding order of the learned commissioners dated 24 May 1997 is hereby affirmed.

Appeal dismissed. Deciding order affirmed.

Reported by Mohd Rizal Abidin